THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

Number 382 ***APRIL 2005***

The usual effect of the attempts of government to encourage consumption is merely to prevent saving; that is, to promote unproductive consumption at the expense of reproductive and diminish the national wealth by the very means which were intended to increase it.

— John Stuart Mill, "Of the Influence of Consumption on Production,"
***Principles of Political Economy*, 1848**

"WEALTH CREATION" IN FOOL'S PARADISE

Pondering current problems, we like to consult the history books. Belonging to the old school of economists — who regarded savings, capital investment and the state of the trade balance as the key gauges of economic health and strength — we always pay particular attention to these three aggregates.

But a paradoxical situation has developed in the world. Countries with rock-bottom savings, sluggish business investment and the worst trade balances have been excelling with strong economic growth, while countries with high savings and strong trade balances are mired in protracted sluggish economic growth. The prime examples of the first group are the United States, Britain, Australia and New Zealand. Outstanding examples of the second group are Japan and Germany.

Sharp falls in saving and soaring trade deficits are nothing new in history. Yet compared to the past, there are two great differences now. One is in the contrasting reaction of policymakers, investors and economists; the other is in the enormous, unprecedented size of today's imbalances.

Until the early 1980s, fairly small trade deficits could cause tremors in the markets, forcing policymakers to take countermeasures. Today, there is generally complete indifference to trade deficits of mammoth size, on the part of both policymakers and the markets.

The following article from Ragnar Bentzel, a professor at Uppsala University, in the *Scandinavian Enskilda Banken Quarterly Review* in early 1980, struck us as an exemplary analysis of the macro problems inherent to falling savings and a rising trade deficit:

> *The lack of balance may be seen as a result of refusing to cut our coat according to our cloth and of attempting to maintain as long as possible our standard consumption by two tricks: namely, in the first place, by borrowing abroad; and secondly, by cutting back investments. In order to understand today's situation, it is important to realize that, for several years now, we have devoted ourselves to "excess consumption" in the sense that we have allowed the share of consumption in the national product to become far too large to permit balanced economic growth. Let us examine this more closely.*
>
> *During the 1960s, 25% of the national product was allocated to investment and 25% to consumption (private and public). In the second half of the 1970s, things began to happen. The investment ratio fell at the same time as the current account balance began to exhibit large deficits. [By] 1979, the savings ratio was not larger than 17%, while the current account deficit rose by one or two percent of national product. On a net basis, i.e. making deductions for wear and tear, the calculation shows that the net savings ratio has fallen from 15% to 6%.*
>
> *One can note that today's large lack of balance, current account deficit, budget deficit, inflation and unemployment have a common denominator, and that is the restructuring of the Swedish economy from industry to public service, or to express it in other words, the deindustrialization of the Swedish economy. This has had a completely devastating effect on the Swedish economy.*

> *If the Swedish economy is to achieve a state of balance again, we shall have to reduce the share of consumption in the national product from 84–85% in 1980 to something like 76–77%.*
>
> *We must get rid of the romantic dream that the Swedish industries of the future will be based on a foundation of gloriously sophisticated industries. It is all right to invest in them; but as for the expansion that must come about, we must devote ourselves also to more trivial occupations such as extracting iron ore from the ground, making steel, pulp, cars and even simpler types of engineering products.*

Sounds familiar, does it not? Not the argument, of course, but the underlying facts. In essence, the Swedish professor argued that Sweden is being deindustrialized through "excess consumption," leading to shrinking capital investment and a rising trade deficit.

Measured by the slump in savings and the size of the current trade deficit, the U.S. economy is clearly in far worse shape today than the Swedish economy was at the time of this article. But hailing its apparently strong real GDP growth, the bullish consensus does not care. Rather, the "asset-driven" — actually, bubble-driven — economic growth is cheered as a successful new paradigm pattern, creating new wealth at an unprecedented rate. Is it really?

Never before have we read and heard so much about wealth creation as today in and from the United States. As we shall explain in detail: It is wealth creation in a fool's paradise.

In America and large parts of the rest of the world, the level of macroeconomic thinking has fallen to such a low that policymakers and most economists are unable to distinguish between true tangible, income-creating wealth and illusionary paper wealth lacking any income creation. It shocks us that central bankers are actively taking part in this deception. From the macro perspective, this celebrated wealth creation is wealth destruction, implying general impoverishment.

LONG RUN VERSUS SHORT RUN

Some time ago, the *Financial Times* published an article by Martin Wolf titled *"Big Spenders Are Keeping the Global Economy Moving."* Wolf writes, *"The driving force of global recovery has been, in short, strong domestic demand in countries with large current account deficits, above all, the United States."* These great spenders, he points out, are the Anglo-Saxons — above all, the United States.

He concludes: *"The spenders of last resort have done the right thing. They must continue to do so. As long as old Europe and old Asia retain structural excess savings, the world economy's dynamism will continue to depend on the Anglosphere's excess consumption and new Asia's excess investment."*

We quoted Mr. Bentzel earlier to highlight the tremendous contrast in thinking about the effects of "excess consumption." He worried about the damaging long-term effects of lower savings and the trade deficit on capital formation and its manufacturing sector in Sweden, depressing future living standards. Moreover, these worries were typical of the consensus thinking at the time.

Who worries today? Not Mr. Wolf, nor anybody else. Today, in general, the future effects of certain events are beyond the horizon of conventional thinking. Among the guidelines for our research in economics is the following remark by Ludwig von Mises: *"What started economic studies was precisely the fact that some men of genius began to suspect that the remoter consequences of an event may differ from the immediate effects visible even to the most simple-minded layman."*

Looking at the economic development in his country from a long-term perspective, the Swedish professor realized that falling savings and a rising trade deficit were ruining the Swedish economy, in particular its manufacturing sector. Today's policymakers and economists in the Anglosphere are completely unable to see this structural erosion because their horizon of thinking is restricted to short-run effects.

THE NEGLECTED KEY QUESTION: COMPOSITION OF GROWTH

Typical of the superficiality of economic thinking in the Anglosphere is the indifference to the changes occurring in the composition of GDP growth, however drastic these may be. During the four years 2000–04, personal consumption captured 87.1% of U.S. real GDP growth, as against a longer-term average of 67%. Including government spending, overall consumption absorbed well over 100% of GDP growth. At the same time, net national saving plunged from 5.8% to less than 1% of GDP.

Clearly, this represents a major structural shift in the U.S. economy's demand-and-output pattern. Implicitly, the disproportionate increase of consumption as a share of GDP depletes the shares available for capital investment and foreign trade. The main victim, for several recognizable reasons, is the manufacturing sector. But U.S. policymakers and economists are completely blind to this massive structural distortion.

Nor do they find anything wrong with the fact that this consumption-driven pattern of economic growth is causing a horrid escalation of indebtedness. Until the early 1980s, each dollar added to GDP caused about $1.60 in additional debt. Since then, the relationship between debt growth and economic activity has dramatically and progressively deteriorated. In 1981, this debt-to-GDP ratio was 1.42-to-1, virtually the same as in 1921. In recent years, there was more than $4 in new indebtedness per $1 increase in GDP.

For the old economists, the allocation of available resources between consumption in the present and capital investment for the future was the key question for creating sustainable economic growth and prosperity. They understood that business spending on fixed investment has much bigger secondary effects on the economy than consumption, and above all, it generates a long-lasting stream of spending and income creation. *First*, it creates tangible income-creating wealth; *second*, it is self-financing; and *third*, it is self-perpetuating through the recycling of depreciations.

In the fourth quarter of 2004, the U.S. current account deficit hit $751.6 billion at annual rate, or 6.3% of GDP. That is up from $135.9 billion in 1997 and $413.4 billion in 2000. In essence, such a deficit implies a corresponding diversion of domestic demand to foreign producers. Over the year as a whole, it absorbed 13% of the increase in spending.

Preventing the current account deficit from dragging GDP growth down requires permanent monetary looseness to offset this growing external drag. On the surface, the Fed has been successful so far in delivering this compensatory demand. But there are two serious drawbacks: *first*, an economic recovery that is extremely lopsided toward consumption and reckless financial speculation; and *second*, unprecedented debt growth.

In general, America's policymakers and economists see the huge U.S. current account deficit as no problem at all. In a recent speech, Fed Governor Ben Bernanke, apparently the top theoretician in the Fed, explained that he is focusing on the *"emergence of a global saving glut in the past 8–10 years"* as the main cause of the U.S. current account deficit. He explicitly stressed that its origin is, therefore, abroad, not in the United States.

For proof he cited an elementary, undisputed macro equation: If a country's saving exceeds its capital investment, the difference shows in a current account surplus. Conversely, if saving falls short of capital investment, it translates into a current account deficit. As Mr. Bernanke put it, *"U.S. net foreign borrowing equals the excess of U.S. capital investment over U.S. national saving."*

Now you know it: America's current account deficit has been soaring due to an excess of capital investment over national saving. Capital investment, indeed, went into excess relative to saving. In that, Mr. Bernanke was right. But it had the exact opposite reason. In reality, personal and national saving collapsed, while nonresidential business fixed investment in 2004 was barely flat with its level in 2000.

And what sent savings into collapse? The answer is common knowledge — the notorious bubble-driven consumer borrowing-and-spending binge. America's trade deficit has its main cause in "excess consumption," and this, in turn, has its main cause in years of unprecedented credit excess.

But do not expect policymakers and economists in America to see or admit this. For some time, the favorite explanation has been that the U.S. current account deficit has its overwhelming cause in the fact that the U.S. financial system is the world's strongest magnet for international capital.

FANCY U.S. RATES OF RETURN

As to the idea that U.S. assets offer the best returns in the world, the bizarre irony is that for years, the official U.S. statistics have been telling precisely the opposite story.

The latest official figures are for 2003 *(Survey of Current Business, October 2004):* Foreign-owned assets in the United States amounted to $9.6 trillion, as against $7.2 trillion U.S.-owned assets abroad. U.S. net foreign investments were $2.4 trillion in the negative. The smaller pool of U.S.-owned foreign assets earned $291.3 billion altogether, while foreign investors earned only $252.5 billion on their far-larger pool of U.S. assets.

The main source of the amazing difference was the extremely low earnings of foreign firms on their existing direct investments in the United States. Amounting to $1,378 billion, of which 72% came from Europe, they earned a miserable $68.6 billion. This compares with $187.5 billion earned by U.S. firms on their direct investments abroad of $1,788.9 billion, of which more than 50% was in Europe.

While the higher volume of such U.S. foreign investments played some role, the dramatic divergence in reciprocal earnings had its main reason in the desperately low returns earned by foreign firms on their direct investments in the United States.

Yet undeterred by the flatly opposite facts, policymakers, economists and the media in the United States stick to the mantra that superior returns on U.S. assets assure the huge capital inflows that are needed to finance the monstrous trade deficit.

Robert J. Barro wrote recently in a *BusinessWeek* article: *"The puzzle is why foreign investors — not just central banks — are willing to hold so much in low-yielding U.S. assets. America's ability to incur foreign debts, essentially without paying for them, is eroding the normal market forces that correct a current account imbalance."*

Central banks, of course, have their special policy reasons. But what is preventing so many European firms from liquidating their low-yielding or even loss-making malinvestments in the United States? Think of the most famous case of Mercedes and Chrysler. Hope for better future gains is certainly one reason.

But there is another, more compelling reason: With the dollar down more than 60% against the euro since early 2002, the sale of U.S. assets would reveal gigantic capital losses. European firms are effectively stuck with their malinvestments in the United States. Essentially, they have no choice but to bet on the dollar's comeback, as happened between 1995 and 2002. This is probably the overwhelming hope around the world — the hope, in other words, that the U.S. recovery will continue.

DELAYED OR ABORTED U.S. ECONOMIC RECOVERY?

Actually, this is the most important economic question in and for the world: Has the U.S. economy's rebound since 2001 been aborted, or is it only delayed? Our rigorous disagreement with the global optimistic consensus over this question begins with four observations that we regard as crucial:

1. In the past four years, the U.S. economy has received the most prodigious monetary and fiscal stimulus in history. Yet by any measure, its rebound from the 2001 recession is by far the weakest on record in the post-World War II period.

2. Record-low interest rates boosted asset prices and, in their wake, an unprecedented debt-and-spending binge on the part of the consumer.

3. What resulted was a badly structured economic recovery, which — due to grossly lacking growth in capital investment, employment and wage and salary income — never gained the necessary traction to become self-sustainable.

4. Sustained and sufficiently strong economic growth implicitly requires a return to strong business fixed capital spending. We see no chance of this happening. Above all, the outlook for business profits is dismal from the macro perspective.

This takes us to the enormous structural changes that the Fed's new monetary "bubble policy" has imparted to the U.S. economy over the years. While consumption, residential building and government spending soared, unprecedented imbalances developed in the economy — record-low saving; a record-high trade deficit; a vertical surge of household indebtedness; anemic employment and income growth from wages and salaries; outsized government deficits; and protracted, unusual weakness in business fixed investment.

None of these shortfalls is a typical feature of the business cycle. Instead, they are all of unusual structural nature. Yet the bullish U.S. consensus simply ignores them, bragging instead about the U.S. economy's resilience and its ability to outperform most industrialized countries.

To be sure, all these structural deformations tend to impede economic growth. Some, like the trade deficit and slumping investment, do so with immediate effect; others become repressive only gradually and in the longer run. Budget deficits stimulate demand as long as they rise. An existing budget deficit, however large, loses this effect. Rather, it tends to become a drag on the economy. In the past few years, clearly, the massive monetary and fiscal pump-priming policies have more than offset all these growth-impairing influences.

Assessing the U.S. economy's future performance, it is necessary to distinguish between two opposite macro forces: One is the drag on the economy exerted by the various structural distortions; the other is the enormous demand pull fostered by the housing bubble and the associated rampant credit creation.

Measured by real GDP growth, the demand pull driven by the housing bubble has, so far, overpowered the structural drags, provided you believe in the accuracy of the GDP numbers. We do not. Yet even by this measure, as repeatedly explained, it is actually by far the U.S. economy's weakest recovery on record in the postwar period. In fact, measuring the growth of employment and wage and salary income, there has been no recovery at all.

Our stance has always been and remains simple. Asset bubbles and their demand effects invariably fade over time; structural effects invariably worsen over time if not attended to. It is our strong assumption that the negative structural effects are overtaking the positive bubble effects.

A BADLY STRUCTURED RECOVERY

We come to another feature of economic recoveries that American policymakers and economists flatly ignore. That is its pattern or composition.

Past cyclical recoveries were spearheaded by three demand components: durable consumer goods, residential building and business fixed investment, regularly following prior sharp downturns caused by tight money during the recession. Importantly, the tight money had always created pent-up demand in these three categories, which promptly catapulted the economy upward when monetary policy eased. For sure, the pent-up demand played a key role in the recovery dynamics.

With its rapid and drastic rate cuts, the Fed rewrote the rules of the traditional business cycle and related policies. It managed a seamless transition from equity bubble to housing bubble. Consumer spending on durable goods continued to forge ahead during the 2001 recession at an annual rate of 4.3%. Residential building never retreated, while business fixed investment took an unusual plunge.

From 2000–04, consumer spending soared by 27.3% on durable goods and 25.4% on residential building. Government spending, too, rose sharply, by 13.9%. Together, the three components accounted for 123% of real GDP growth.

But in the rest of the economy, it was all misery. Despite a modest rebound, business nonfinancial fixed investment in 2004 was still down 0.2% from 2000. Exports of goods posted a minimal gain of 0.1%, whereas imports of goods shot up by 16.5%.

U.S. POLICY IS UNIQUE

Thanks to the sharp decline in interest rates over the last few years, sharply inflating house prices have been a rather common feature around the world. Still, there is one crucial difference among the countries concerned. There are countries in which the rising house prices have fueled borrowing-and-spending binges by private households, and there are others where these binges are completely absent. Typical for the first pattern are all Anglo-Saxon countries; typical for the latter are most eurozone countries.

Even among the Anglo-Saxon bubble economies — meaning countries where the house-price inflation led to borrowing-and-spending sprees — the United States is a unique case. It concerns the official and public attitude to such bubble-driven economic growth.

The United States is the one and only country in the world where monetary policy was systematically designed toward the goal of inflating the market value of assets — stocks, houses and bonds — virtually making wealth creation through inflating asset prices their explicit goal.

In Britain and Australia, the associated borrowing-and-spending binges are even worse than in the United States. Yet there is a general apparent reluctance to embrace this growth model as an unmixed blessing. Central bankers who celebrate this as "wealth creation" and even explicitly animate people to exploit the possibilities of easy credit to lift their spending on consumption are unique to America.

For generations of economists, it used to be a truism that "wealth creation" implies capital formation in terms of generating income-creating tangible assets. The emphasis was on capital formation and the associated income creation. To indiscriminately put this label of "wealth creation" on rising asset prices in the absence of any income creation is plainly a novel usurpation of this concept. It is in essence wealth creation through a stroke of the pen.

THE GREAT WEALTH DECEPTION

Measured by their net worth (market value of household assets minus debts), American households have amassed unprecedented riches in the past few years, despite spending in excess of their current income as never before.

The first question springing to mind in the face of this "wealth miracle" is its cause or causes, leading immediately to the next question: whether or not this drastic increase of house prices relative to the consumer price index has to be seen as a "bubble," which sooner or later have the habit of bursting.

In old textbooks, you would read that capital value is increased by higher saving. But in the U.S. case, capital values have soared while personal and national saving has collapsed. What else, then, has the power to lift asset prices?

Everybody knows the answer, but few want to admit it: Lured by artificially low interest rates and easily available credit, private households have stampeded as never before into the purchase of homes, boosting their prices. Artificially low interest rates and easily available credit are, actually, the key features that specifically qualify an asset bubble.

The growth of home mortgages exploded from an annual rate of $368.3 billion in 2000 to an annual rate of $884.9 billion in 2004, compared with a simultaneous increase in residential building from $446.9 billion to $662.3 billion. Altogether, the United States experienced a credit expansion of close to $10 trillion during these four years. This

equates with simultaneous nominal GDP growth of $1.9 trillion. America's financial system is really one gigantic credit-and-debt bubble.

Our general misgivings about "wealth creation" simply through rising house prices has still another reason, however, and that is the way housing values are calculated. The conventional practice in America is to treat the whole existing housing stock as being worth the last trade. We do not think this makes sense, considering that current sales are always marginal to the whole capital stock.

This way of calculating wealth creation naturally explains the extraordinary rapidity with which it can deluge an economy, creating trillions of dollars of such wealth in no time. For sure, this contrasts wondrously with the tedious process of generating prosperity through saving, investment and production.

MISTAKEN EMPHASIS ON THE CPI

In earlier studies published by the International Monetary Fund about asset bubbles in general, and Japan's bubble economy in particular, the authors repeatedly asked why policymakers failed to recognize the rising prices in the asset markets as asset inflation. Their general answer was that the absence of conventional inflation in consumer and producer prices confused most people, traditionally accustomed to taking rises in the CPI as the decisive token for inflation.

It seems to us that today this very same confusion is blinding policymakers and citizens in the United States and other bubble economies, like England and Australia, to the unmistakable circumstance of existing rampant housing bubbles in their countries.

Thinking about inflation, it is necessary to separate its cause and its effects or symptoms. There is always one and the same cause, and that is credit creation in excess of current saving leading to demand growth in excess of output. But this common cause may produce an extremely different pattern of effects in the economy and its financial system. This pattern of effects is entirely contingent upon the use of the credit excess — whether it primarily finances consumption, investment, imports or asset purchases.

A credit expansion in the United States of close to $10 trillion — in relation to nominal GDP growth of barely $2 trillion over the last four years since 2000 — definitely represents more than the usual dose of inflationary credit excess. This is really hyperinflation in terms of credit creation.

In other words, there is tremendous inflationary pressure at work, but it has impacted the economy and the price system very unevenly. The credit deluge has three obvious main outlets: imports, housing and the carry trade in bonds. On the other hand, the absence of strong consumer price inflation is taken as evidence that inflationary pressures are generally absent. Everybody feels comfortable with this (mis)judgment.

FOOL'S PARADISE

We come to the most important question of all for the U.S. economy and, in its further implications, for the world economy. It concerns the head title and the main theme of this letter: "*'Wealth Creation' in Fool's Paradise.*"

Understandably, people feel richer when the prices of the assets they own increase, particularly when the policymakers and all the financial experts are hammering this idea into their heads through the media day after day, imploring them to buy and spend.

As we shall explain, this is a gross misconception of wealth creation, not only from the macro perspective, but also from the perspective of the individual house owner. Strikingly, this talk of wealth creation through rising asset prices is literally confined to the Anglo-Saxon countries. In the eurozone, it is a topic completely ignored.

American policymakers and economists have completely lost sight of the fact that capital formation through saving and investment is the critical mass in the process of creating current and future economic growth and prosperity. But in the United States, this critical mass is shrinking under the pressure of excess consumption.

This reminds us of a remark by Ludwig von Mises: *"It may sometimes be expedient for a man to heat the stove with his furniture. But if he does, he should know what the remoter effects will be. He should not delude himself by believing that he has discovered a wonderful new method of heating his premises."*

There are many different ways for an individual to make provisions for the future. Yet from the macro perspective, it ultimately boils down to the one single key question of how much aggregate output and income will be available in 10, 20 or 30 years to be shared between the active workforce and the retired people, when we do this or that today. It is undisputed that maximizing this level crucially depends on current saving.

In principle, there are, from the macro perspective, two ways to maximize both current and future income: *first*, by accumulating foreign assets through a protracted export surplus; and *second*, by increasing the domestic capital stock through saving and investment.

But what is happening in the United States is the exact opposite of capital accumulation. Instead of accumulating foreign assets, it is rapidly accumulating foreign debts. And internally, instead of expanding its capital stock for higher future output and income growth, there is record accumulation of unproductive debt collateralized by inflating asset prices.

According to the latest available figures, U.S. net domestic fixed investment increased by $47.6 billion, to $670.3 billion, in 2003. This compares with a current annual increase in foreign indebtedness by about $700 billion.

The important point to see from the macro perspective is that the inflating asset prices have played the key role in propelling consumption in the United States to an exorbitant and patently unsustainable level. Far from stimulating capital investment, it has pulled resources away from capital investment and foreign trade.

There is, actually, a very simple rule about wealth creation. It says capital decreases when a nation consumes more than it produces. But capital increases when a nation produces more than it consumes. Of course, that is equally true for firms and private households.

But have not the homeowners made a true gain thanks to rising house prices? On closer look, their gain, too, is an illusion. Rising house prices mean, in essence, that the dollar and dollar incomes depreciate against the market value of residential housing. This is the point from which our thinking has to start.

What happens is that owners of houses are spared this loss. That is their true gain. However, when they sell their house and buy a new one of equivalent standard in an equivalent location, they have to pay the higher price. There has been no permanent gain, neither in money nor in comfort. Their only advantage, to repeat, is avoidance of the loss that the non-owners of houses have suffered. It is an advantage, of course, but one very different from wealth creation.

Asking American friends or acquaintances about the affordability of their housing, the typical answer is that they are living in a house or apartment that they could no longer afford with their present income. On closer look, the reality behind the inflating house prices is general impoverishment, leaving people on the whole poorer, not richer.

Yet this housing inflation has had one effect that the American consensus finds highly desirable. For over four years, it accelerated U.S. economic growth through the consumer borrowing-and-spending binge, which it fueled.

If you think that excess consumption is better than too little consumption, this is certainly an achievement. If you regard the outcome as an unsustainable and damaging structural distortion, as we do, the U.S. economy is an accident waiting to happen. Consider again that over the four years since 2000, personal consumption, residential building and government spending have accounted for 123% of U.S. real GDP growth.

The looming structural problem, really, is that the prodigious monetary and fiscal pump-priming policies of the past few years have provided enormous traction to consumer spending and financial speculation — too much of it, in fact — while they have miserably failed in relation to business capital investment.

FINALLY, THE U.S. TRADE DEFICIT FINDS ATTENTION

Lately, the U.S. trade deficit has gained growing attention. Its key role in determining the dollar's exchange rate has finally been recognized. Yet American arguments reveal a lot more complacency and indifference than worry.

This complacency starts with the widespread view that the huge U.S. trade deficit primarily reflects slow economic growth and excessive saving abroad, and it ends with the happy conclusion that the U.S. economy's superior growth and wealth performance assures the large capital inflows it requires to finance the deficit.

Others rather rely on the Asian central banks to prevent a steeper and damaging fall of the dollar. Asian central banks, they argue, have deliberately chosen to peg their currencies — either rigidly or more loosely — to the dollar, defending these exchange rates by heavy dollar purchases. While they may suffer heavy losses on their rapidly rising dollar holdings, they readily accept this loss because keeping their exports cheap in support of their domestic economic growth is the far more important consideration for them. In fact, they are mainly financing their own exports.

In recent months, a series of papers from three economists at Deutsche Bank — M. Dooley, D. Folkerts-Landau and P. Garber — found some publicity. In their view, a newly symbiotic world has developed in which Asian central banks readily finance the excessive spending by the American consumer, reflecting a revived Bretton Woods, the system of fixed exchange rates after the Second World War. *"It is in everyone's best interest that this continues"* is their conclusion, finding many ready believers in the world.

We would say it is in everyone's *perceived* interest that this development is beneficial to both sides and that it should therefore, hopefully, continue. For sure, it does look mutually beneficial at first sight, but more careful thinking should make it clear that destructive implications are looming in the longer run.

First of all, it is a badly flawed view that the U.S. trade deficits primarily reflect faster U.S. economic growth rates. Historically, just the opposite is true. It has been typical that fast-growing economies regularly run a trade surplus. In the past, booming Germany and Japan ran a surplus for decades, and presently so does Asia ex Japan, with economic growth rates of more than twice that of the United States.

In reality, what determines the state of a country's trade balance are two specific conditions: *first*, the level of domestic saving; and *second*, the pattern of growth — consumption-led or investment-led. The United States has consumption-led growth with record-low national savings. With much higher economic growth, China has a chronic trade surplus due to record-high rates of saving and investment.

Economic growth biased toward high capital investment is implicitly also biased toward strong exports and a trade surplus. In contrast, economic growth biased toward high consumption invariably weakens investment and exports and boosts imports. Capital formation through saving and investment are the decisive basics behind a country's trade performance. In fact, they are the decisive basics for healthy, sustainable economic growth.

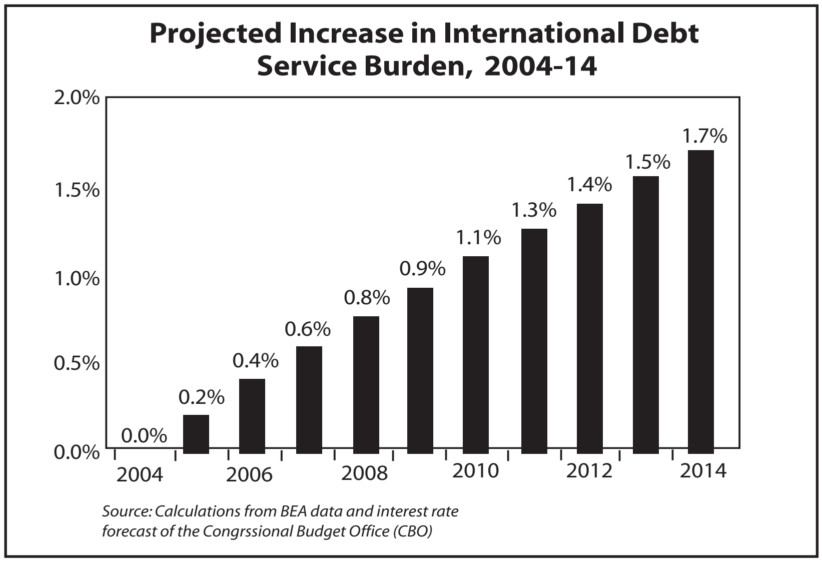
WHY A TRADE DEFICIT MATTERS

Discussing the U.S. trade deficit, American policymakers and economists mainly ponder its sustainability. There is very little or no thinking at all about possible deleterious implications for the U.S. economy, at least not in public.

There are, in effect, two different kinds of damages: one is a soaring bill of compound interest on the soaring foreign indebtedness; and the other is a shift in the economy's resource allocation from investment and international trade toward consumption.

In a recent report titled *Debt and the Dollar*, the Economic Policy Institute in Washington presented a chart projecting the debt service on foreign debts over 10 years into the future based on two assumptions: *first*, that the U.S. current account deficit neither improves nor worsens; and *second*, that GDP will grow at the rate forecast by the Congressional

Budget Office and that the interest rate on the soaring foreign debts will follow the projections of the CBO.



First of all, these assumptions are too good to be true. Even then, the debt service costs just from the additions to the foreign indebtedness over the next 10 years would rise from zero in 2004 to 1.7% of GDP in 2014, the equivalent of $250 billion in 2004 dollars. Net U.S. foreign indebtedness would then hit 64% of GDP, up from 24% at present.

We would say this surge in debt service costs makes the U.S. trade deficit flatly unsustainable at its present size. In reality, it is rapidly increasing in relation to GDP growth due to an ongoing shift in the allocation of available resources away from investment and toward consumption. Its most spectacular and also most frightening part is the progressive hollowing out of the U.S. manufacturing sector.

Consider that U.S. industrial output has increased by a paltry 1.5% since 2000, as against a simultaneous increase in real GDP by more than 10.4%. Manufacturing has decoupled from spending growth, as measured by GDP. More than all of the job losses before 2003 — around 3 million — were in manufacturing. Growth is exclusively in services, health service in particular.

A RUINOUS TRADE DEFICIT

Assessing the various imbalances in the U.S. economy, we regard the huge trade deficit as the most dangerous for two reasons: *First*, through the currency link, it threatens the stability of the whole financial system; and *second*, it wrecks the manufacturing sector. In new American parlance, though, this is creative destruction.

We fully realize that the statement about wrecking U.S. manufacturing will meet protest and ridicule from most American economists. They entertain an almost religious belief that outsourcing, globalization and cheap Chinese products are rendering long-run benefits to the United States as a whole by providing cheap imports, though this may hurt some people in the short run.

The apologists of the U.S. trade deficit like to quote the famous David Ricardo (1772–1823) as their most prominent witness for the mutual advantage of international trade, even if one country is cheaper in all products. One such example he cited was the trade between England and Portugal in wine and cloth. Although Portugal produces both goods cheaper than England, it specializes in wine as the product with the greatest comparative advantage.

He was right. Yet any comparison with today's grossly imbalanced trade between the United States and Asia is misplaced. At Ricardo's time, international trade was governed by the gold standard, under which even small chronic trade deficits were flatly impossible.

At issue are not the advantages of outsourcing and globalization as such; rather, at issue are the immediate and long-term implications of the factual, monstrous U.S. trade deficit for the U.S. economy. This deficit is lately exceeding an annual rate of $700 billion, after $413 billion in 2000.

In essence, this deficit implies that this amount of domestic spending is diverted from American producers to foreign producers. The most important next point to realize is that this loss of spending and associated income

creation does not distribute across the whole U.S. economy. No — it is narrowly concentrated on the relatively small manufacturing sector, accounting today for less than 15% of U.S. GDP.

American economists cheer the U.S. economy's ability to run such a huge trade deficit for an indefinite period of time, thanks to the largess of the Asian central banks in financing this spending excess. What they are cheering is America's deindustrialization. That, namely, is the somber reality behind the easy financing of the monstrous U.S. trade deficit.

The following quote from Joan Robinson, a brilliant economist of the 1930s, has put our elaborate reflections about the extremely harmful economic implications of the huge U.S. trade deficit for the U.S. economy into a few, easily comprehensible sentences:

> ***The deficit country is absorbing more, taking consumption and investment together, than its own production; in this sense, the economy is drawing upon savings made for it abroad. Whether this is a good bargain or not depends upon the nature of the use to which the funds are put. If they merely permit an excess of consumption over production, the economy is on the road to ruin.***

A VERY DIFFERENT BUBBLE

What about the benefits that the Asian countries gather from their dollar pegging and the export surplus with the United States? Undisputedly, China is the key variable. Over the three years 1997–2000, its central bank increased its foreign reserves rather modestly, from $142.7 billion to $168.3 billion. Last year alone, they soared by $206.7 billion, to $609.9 billion, with almost half of this increase occurring in the last three months of the year.

These numbers compare with total exports of $593.36 billion and a small export surplus of $31.98 billion in 2004. Most of the Chinese dollar deluge resulted, therefore, from speculative inflows betting on the Chinese currency's revaluation. China's annual trade surplus with the United States is, actually, around $165 billion, but most of it dissipates in deficits with other countries.

All these numbers hardly make exciting reading. What gives them their great global thrust is the fact that the Asian central banks generally monetize their trade surpluses. Purchasing dollars to prevent the appreciation of their currency, they flood their commercial banks with central bank deposits (high-powered reserve money). This has stoked the Chinese economy through runaway credit expansion into its own runaway boom — with pronounced bubble features — which, in turn, has been stoking other booms in Asia.

The typical features of bubble economies are unsustainable gross disproportions in their growth pattern. Ironically, the disproportions in Asia are diametrically opposite to those in the economies of the Anglosphere. Thanks to record-high savings and investment ratios, the production side in these countries is outpacing the demand side. Anglo-Saxon monetary looseness delivers the missing demand to fill the output-spending gap. It seems a perfectly complimentary system. Americans do the consuming, while Asians do the producing.

YET THERE IS A TIPPING POINT

For sure, it has worked satisfactorily over the past few years. But the inherent structural distortions on both sides are not standing still. They keep worsening. The U.S. trade deficit is relentlessly increasing as a share of GDP. In the fourth quarter of 2004, it hit 6.3% of GDP, up from 4.5% a year before.

As we pointed out earlier, the trade deficit is wrecking U.S. manufacturing for a manifest reason: It is the one sector in the economy in which the deficit is concentrated. In the fourth quarter of 2004, fully 98% of the U.S. current account deficit accrued from U.S. foreign trade in goods.

Our stance concerning the U.S. economy has been quite simple since early last year. During 2003–04, it got a tremendous impetus from the most prodigious monetary and fiscal pump-priming in history. The result, despite all

the hype, has been the weakest and most lopsided economic recovery in the postwar period.

Consumer spending responded promptly and strongly to the extraordinary stimulus. Yet it was clear right from the start that a self-sustaining recovery of sufficient vigor would require strong support from rebounding business capital investment with its implicit dynamics of job creation and income generation. It has not happened. There have been improvements during 2004, yet they remain grossly subpar for self-sustaining economic growth.

Under these circumstances, we read with growing amazement reports portraying a U.S. economy bursting with vigor now that "*wages and salaries are growing at a healthy pace and corporations are awash in cash*" (*BusinessWeek*, March 28, 2005). For many commentators, the Goldilocks economy has returned in full force with a combination of strong growth, relatively low inflation and record profitability.

CONCLUSIONS

For the U.S. economy, huge twin deficits, excess consumption, the demise of manufacturing, near-zero savings, supersized unproductive debt and poor profitability of nonfinancial activity all speak of an unsustainable economic recovery in the United States. Not surprisingly, manufacturing firms have drastically cut back on their investment in industrial plant and equipment. Since 2000, the former is down 60% and the latter 10%.

In our view, the new hype about the U.S. economy is grossly out of whack with the extremely vulnerable economic and financial situation. Compared to an inflation rate of more than 3%, the monetary stance appears, admittedly, still extremely accommodative. But that is the wrong focus.

The looming imminent danger is that relatively moderate further increases of interest rates, short- and long-term, may prick the highly leveraged bond bubble with ghastly ramifications for the stock market and the housing bubble. It greatly amazes us that this threat is finding no attention at all. Keep in mind: The U.S. economy has been driven by inflating asset prices.

It has to be realized that the U.S. economy in the past few years has become addicted to runaway credit growth — rising to $2.7 trillion last year. In the absence of new saving, its accommodation depends completely on capital inflows and ever-increasing financial leveraging or carry trade. A large part of this credit expansion is funded by foreign central banks and borrowing in cheaper foreign currencies, mainly yen. Yet the far greater part of this credit expansion has to be funded domestically.

It looks like the Fed will keep raising interest rates until something breaks in the economy or in the asset markets. The aggregates to watch are the asset markets. They led the economy's upturn, and they will lead its impending downturn.

"Capitulation" of consumer borrowing is only a question of time. Assessing the U.S. economy's further growth, we attach crucial importance to the absence of "pent-up demand" in consumer durables and housing.

THE RICHEBÄCHER LETTER

AGORA FINANCIAL

Dr. Kurt Richebächer, Editor
Published by Agora Financial
Addison Wiggin, Exectutive Publisher
Greg Grillot, Marketing Manager

Richard Barnard, Associate Editor
Erik Kestler, Editorial Assistant
Kate Southerland, Editorial
Elliana Brocato, Graphic Design

For subscription services and inquiries, please write to: THE RICHEBÄCHER LETTER, 808 St. Paul Street, Baltimore, MD, 21202. Subscription orders may be placed toll free from inside the U.S. by calling (800) 433-1528, or from outside the U.S. by calling (203) 699-2900. Fax (410) 454-0407. Web: www.richebacher.com; richebacher@AgoraFinancial.com. Subscription rates: in the U.S.: $497. Outside U.S.: $545. Published monthly.